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A PASSION FOR EXCELLENCE

EXCLUSIVE EXCERPTS FROM THE NEW SEQUEL TO "IN SEARCH OF EXCELLENCE"

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TROUBLE IN RETAILING: TOO MANY STORES

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EYEING THE LETTERS

Letters of credit, that is. Regulators are looking hard at these off-balance-sheet items.

FEDERAL BANKING regulators are fretting about the spectacular growth of something called standby letters of credit. Since 1980 the letters, by which a bank guarantees a customer's debt to a third party, have tripled in volume to become a $147-billion-a-year business. Big players like Citicorp may earn more than $100 million annually in fees from them. But regulators worry because the letters do not appear on the bank's balance sheet. That means the risks inherent in them are not backed by federally prescribed levels of capital, as loan risks are.

Standby letters of credit are a modern twist on trade agreements pioneered by Phoenician merchants more than three milleniums ago. With the traditional variety, a buyer pays his bank the full cost of a shipment of goods, and the bank issues a letter of credit to the seller, holds the buyer's money in escrow until the goods are delivered, and then pays the seller. By contrast the purchaser of a typical standby letter of credit is a borrower who pays the bank only a small fee—usually less than 1% of the letter's face value per year—in return for the bank's promise to pay if the purchaser defaults on the obligation covered by the letter.

Standby letters took off in the volatile economic climate of the early 1980s as a means of assuaging jittery investors. Major purchasers include municipalities issuing new types of tax-exempt bonds and companies floating commercial paper, the volume of which has exploded. In effect, the purchaser borrows the bank's high credit rating so it can sell the bond or paper at, say, 13.5% interest instead of the 15% it would otherwise have to settle for on the basis of its own creditworthiness.

In a speech last month, H. Joe Selby, a senior deputy to the Comptroller of the Currency, suggested that banks with extensive off-balance-sheet risks—letters of credit being his prime example—should be subject to even tougher capital requirements than the stringent ones that went into effect April 15. The question is whether formal regulation is needed. One possibility: lumping letters of credit with assets in computing the capital requirement, but—in recognition that they are less risky than a normal portfolio of loans—at only half their value.

Many bankers expect some such regulation by next year. Predictably, some don't like the prospect. They say the letters are safe, pointing out that there have been no major losses on them. Nevertheless, according to several people in the business, the banks may already be scaling back. "From here on, I think you'll see banks growing their letters of credit more in proportion to the general growth of their loans," says Carleton R. Haswell, a senior vice president at Chemical Bank. Even if that happens, banks' exposure will remain substantial. Many letters have been issued that guarantee payment for up to ten years—plenty of time for another recession to work its mischief.

— John Paul Newport Jr.

BANK	TOTAL 1984 VOLUME in millions	INCREASE FROM 1983	AS PERCENT OF STOCKHOLDERS' EQUITY
Citicorp	$19,946	15.5%	310
Manufacturers Hanover Trust	$12,031	22.8%	462
BankAmerica	$11,392	11.4%	221
Chemical	$9,943	22.4%	391
Bankers Trust	$9,000	15.4%	469

The Rise in Standby Letters of Credit

Five banks accounted for more than a third of all standby letters of credit outstanding last year. These off-the-balance-sheet obligations far outstripped shareholders' equity in the institutions.